

Metropolitan King County Council

Maggi Fimia, *District 1*
Cynthia Sullivan, *District 2*
Louise Miller, *District 3*
Larry Phillips, *District 4*
Dwight Pelz, *District 5*
Rob McKenna, *District 6*
Pete von Reichbauer, *District 7*
Greg Nickels, *District 8*
Kent Pullen, *District 9*
Larry Gossett, *District 10*
Jane Hague, *District 11*
David W. Irons, *District 12*
Les Thomas, *District 13*



Cheryle A. Broom
King County Auditor

516 Third Avenue, Room W1020
Seattle, WA 98104-3272

(206) 296-1655
TTY/TDD 296-1024

MEMORANDUM

DATE: September 11, 2001

TO: Metropolitan King County Councilmembers

FROM: Cheryle A. Broom, County Auditor

SUBJECT: Financial Audit of Institutional Network Project

Attached for your review is the audit report of the Institutional Network (I-Net) project. The primary objective of the audit was to review revenues and other receipts, and expenditures and encumbrances to ensure that transactions are supported by documentation and, thus, determine whether the resulting fund balance for the county's I-Net capital project is fairly stated. We also reviewed the accounting methodology for the capital and operating costs of the I-Net activities.

The general audit conclusion is that the recorded I-Net project life-to-date revenues and bond proceeds, expenditures and encumbrances, and the resulting I-net project fund balance of \$1,589,000 at June 30, 2001 were fairly stated in all material respects.

The executive response, included in Appendix, indicates general concurrence with our audit findings and recommendations. Responses to the Individual findings and recommendations are incorporated into the audit text.

The Auditor's Office sincerely appreciates the cooperation received from the management and staff of the Department of Information and Administrative Services.

CB:BG:yr:areport.doc

FINANCIAL AUDIT

INSTITUTIONAL NETWORK (I-NET) PROJECT



Cheryle A. Broom, CGFM, CIG, King County Auditor
Bert Golla, CPA, Senior Financial Auditor
Makoto (Mac) Fletcher, CPA, Principal Financial Auditor
Kimberly Dutton Cregeur, Management Auditor

TABLE OF CONTENTS

	<u>PAGE</u>
Report Summary	ii
Auditor's Mandate	vii
Chapters	
Chapter 1	Introduction 1
Chapter 2	I-Net Revenues and Bond Proceeds, Expenditures and Encumbrances, and Fund Balance 5
Chapter 3	Capitalization of I-Net Project Costs and Enterprise Fund for I-Net Operations 15
Exhibits	
Exhibit A	I-Net Funds (Fund Nos. 3481 and 3482) Revenues and Bond Proceeds From 1995 Through June 30, 2001 6
Exhibit B	I-Net Funds (Fund Nos. 3481 and 3482) Appropriations and Expenditures From 1995 Through June 30, 2001 8
Appendix	Executive Response 21

Abbreviations

CTV	Civic Television
GAAP	Generally Accepted Accounting Principles
I-Net	Institutional Network
PEG	Public, Educational, and Government
TCI	Tele-Communications, Inc.
ITS	Information and Telecommunications Services Division

REPORT SUMMARY

Introduction

The financial-related audit of the Institutional Network (I-Net) project was initiated at the request of the Metropolitan King County Council and included in the council-adopted 2001 Auditor's Office work program. The I-Net, as proposed by the executive, is a \$22.5 million capital project to provide fiber optic cable connectivity to over 300 public facilities in King County. The sources of funds were fees collected from the cable subscribers by the franchisee, capital contribution from the franchisee, proceeds from the county's limited general obligation bonds, and investment earnings. During the council's 2001 budget review, questions were raised regarding the amounts expended and encumbered for the I-Net project and the balances available in the fund.

Audit Objective

The audit objective was to review revenues and bond proceeds, and expenditures and encumbrances to ensure that transactions are supported by documentation and, thus, determine whether the resulting fund balance for the county's I-Net capital project is fairly stated. We also reviewed the accounting methodology to determine the need for capitalizing the costs incurred for the I-Net construction project and potential need to create a separate fund to account for the I-Net activities after the network becomes operational.

General Conclusion

The general conclusion is that the recorded I-Net project life-to-date revenues and bond proceeds, expenditures and encumbrances, and the resulting I-Net project fund balance of \$1,589,000 at June 30, 2001 were fairly stated in all material respects.

SUMMARY OF FINDINGS AND RECOMMENDATIONS

Finding 2-1 (Page 9)

Revenues and bond proceeds, and expenditures and encumbrances for the I-Net project accounted for in the county's financial system were fairly stated in all material respects.

The audit examined, on a test basis, evidence supporting the revenues and bond proceeds, and expenditures and encumbrances for the recorded I-Net project life-to-date amounts. Based on the audit work, cumulative revenue and bond proceeds of \$21,231,778 (see Exhibit A) and expenditures of \$14,110,848 (see Exhibit B) from 1995 through June 30, 2001, are shown appropriately in the county's accounting records. We have also determined that the amount of encumbrances of \$5,254,929 at June 30, 2001 is fairly stated in all material respects.

Finding 2-2 (Page 10)

The I-Net project had remaining available funds of \$1,589,000 as of June 30, 2001.

The audit has determined that the I-Net fund balance, derived as net of receipts less expenditures, encumbrances and an adjustment for arbitrage rebate liability (see Finding 2-4), at June 30, 2001 is approximately \$1.6 million.

Finding 2-3 (Page 11)

The county may be liable for about \$337,000 in retail sales/use tax from the purchase of networking equipment.

We found that the county may be liable for certain unpaid Washington State sales/use tax on the value of network

equipment and software. While the county has received and paid for equipment and services in the amount of \$3.9 million from the vendor, and the vendor invoices have included the sales/use tax, the county has not remitted sales/use tax totaling \$337,000 through May 2001. There appears to be a lack of clarity regarding the party responsible: the vendor or the county.

The audit recommended that the county determine whether vendor or county is responsible for the remittance and, upon such determination, the county should remit the calculated retail sales/use tax to the vendor or directly to the state.

Finding 2-4 (Page 12)

The I-Net project fund incurred an arbitrage rebate liability of \$277,000 to the U.S. Treasury from investing proceeds of tax-exempt bonds in higher yield rate investment instruments than stated on the bonds.

We found that I-Net project fund incurred an arbitrage rebate liability of approximately \$277,000 because the fund's investment earnings have exceeded the borrowing interest costs of the general obligation bonds. This excess "profit" resulted, primarily, from the county's failure to use the bond proceeds, as opposed to other revenue sources, to pay for I-Net project costs first. However, the estimated arbitrage rebate liability has been accrued and funds have been set aside to be rebated to U.S. Treasury Department.

The audit recommended that the county should use proceeds from tax-exempt general obligation bonds first to pay for I-Net project costs.

The audit further recommended that the Department of Finance should develop a financial policy regarding the priority of disbursing bond proceeds when capital projects are funded by multiple sources.

Finding 3-1 (Page 16)

The project costs related to Civic Television (CTV), which is complete and operational, should be capitalized and accounted for under the general fixed assets account group.

The construction cost, amounting to about \$1.24 million, for CTV was funded out of I-Net capital project fund. While the CTV project has been complete and operational since 1997, the cost of the project has not been recorded into the county's fixed asset account group.

The audit recommended that the capital project costs related to CTV should be classified to general fixed asset account group in accordance with generally accepted accounting principles (GAAP).

Finding 3-2 (Page 16)

The I-Net operation does not have a separate fund to account for its operating revenues and expenses, and its operating activities have not been budgeted.

We found that, effective July 2001, approximately 70 I-Net sites have been completed and are operational. While these sites are generating revenues in the form of customer subscription fees, the I-Net operation does not have a separate fund to account for its operating revenues and expenses. Additionally, the completed portion of I-Net should be capitalized as a fixed asset to recognize the matching of revenue to the relevant expenditures. It should be noted, however, that the I-Net

operation does not have an approved budget for 2001 to incur and pay expenses for the I-Net operation.

The audit recommended that the executive submit a proposed ordinance requesting the council to approve the creation of a separate enterprise fund to account for revenues and expenses of the I-Net operation.

The audit further recommended that the executive should submit to the council a request to approve a supplemental budget for the I-Net operation in 2001.

The audit further recommended that the Department of Finance should capitalize the portion of I-Net sites that are operational, in accordance with GAAP.

AUDITOR'S MANDATE

The institutional network (I-Net) project was reviewed by the County Auditor's Office pursuant to Section 250 of the King County Home Rule Charter and Chapter 2.20 of the King County Code. The audit was performed in accordance with generally accepted government auditing standards, with the exception of an external quality control review.

1 INTRODUCTION

Background

The financial-related audit of the institutional network (I-Net)¹ project was initiated at the request of the Metropolitan King County Council and included in the council-adopted 2001 Auditor's Office work program. During the council's 2001 budget review, questions were raised regarding the amounts expended and encumbered for the I-Net project and the balance available in the fund. The information provided by the executive staff was not considered sufficient to address the questions raised by the council. Hence, the council was interested in determining the amount of revenues and bond proceeds, expenditures and encumbrances, and available fund balance for the I-Net project.

In July 1996, the Metropolitan King County Council adopted Ordinance No. 12391 renewing the county's cable franchise agreement for ten years with Tele-Communications, Inc. (TCI), now owned by AT&T. As part of the renewal agreement, TCI committed to construct and maintain a dedicated fiber optic network called the institutional network (I-Net) for use by the county and other public institutions. The sources of funds for the construction and development of I-Net came from the "Public, Educational, and Government" (PEG) revenue fees that are paid by cable subscribers in the unincorporated King County areas, TCI contributions to the project, proceeds from limited general obligation bonds, and investment earnings. The county has established two separate funds, one for the bond proceeds and the other for all other revenues, to account for the I-Net capital construction revenues and expenditures. Once completed, the

¹ Institutional network means a communications network related to and physically joined with the cable system which is not generally available to residential subscribers of the cable system in King County.

county is to lease the I-Net fiber optic infrastructure from AT&T and manage the network.

The I-Net, as proposed by the executive, is expected to provide fiber optic cable² connectivity to over 300 public facilities in King County at an estimated total construction cost of \$22.5 million. This fiber optic high-bandwidth network is designed to provide capability for transmission of voice, video, and data applications. The purpose of these applications is to benefit the public, schools, and government by providing such features as distance learning, video conferencing for meetings and assemblies, voice transmission, and data internet access. The targeted key client agencies include the following: school districts, King County libraries, King County superior and district courts, public defenders, community colleges, universities, police, county, and other government agencies.

The county contracted with the cable franchisee, AT&T Broadband, to install fiber optic infrastructure at the various selected I-Net sites in King County, and with GTE Communications Corporation and other vendors to provide networking equipment and software. The construction began in early 1998 and is expected to be complete by mid-2002. However, a portion of the network is operational. As of July 1, 2001 there were 34 King County agency sites, 34 King County library system sites, and two city of Seattle public utility sites.

The Information and Telecommunications Services (ITS) Division of the Department of Information and Administrative Services monitors and manages the I-Net project.

² Defined as jacketed bundles of one or more optical fibers, each of which is capable of transporting audio, video, and data forms of communication.

Audit Objectives

The audit objectives were to review revenues and bond proceeds, and expenditures and encumbrances to ensure that transactions are supported by documentation and, thus, determine that the resulting fund balance for the county's I-Net capital project is fairly stated. We also reviewed the accounting methodology to determine the need for capitalizing the costs incurred for the I-Net construction project and potential need to create a separate fund to account for the I-Net activities after the network becomes operational.

Audit Scope and Methodology

The audit scope was limited to the review, on a test basis, of documentation and accounting for the revenues and bond proceeds, expenditures and encumbrances, and fund balance available for the I-Net capital project for the period from 1995 to June 30, 2001. The methodology included a review of county ordinances, motions, and administrative policies and procedures; budget, project, and ARMS financial reports and other reports; and contracts, vouchers, invoices, and other supporting records. Interviews of I-Net project management and staff were also conducted. Furthermore, confirmation requests were sent to the franchisee and major vendors for the purpose of reconciling revenues received by the county and the accounts payable to the vendors.

In June 2001, the county council hired a consultant to review the county's I-Net project and make recommendations to the council regarding its operation, administration, and maintenance, including the marketing of its services.

[Blank Page]

2 I-NET REVENUES AND BOND PROCEEDS, EXPENDITURES AND ENCUMBRANCES, AND FUND BALANCE

Background

This chapter focuses on the sources of revenues and bond proceeds, expenditures and encumbrances, and the remaining fund balance available for the completion of I-Net. The documentation to support these transactions was reviewed, on a test basis, to determine whether the amounts reported in the county's financial records and reports were free of material error. Our audit does not determine whether the amounts currently available and the amounts to be generated and received are sufficient to enable a successful completion of the project and to ensure the operation of the network in the future.

Revenues and Bond Proceeds

The I-Net capital project is funded from the following sources of funds:

- General obligation bonds
- Public, education, and government (PEG) revenue fees
- Grants or contributions from franchisee
- Investment earnings

Exhibit A shows the revenues and bond proceeds for the I-Net project from 1995 through June 30, 2001.

EXHIBIT A

I-Net Funds (Fund Nos. 3481 and 3482)

Revenues and Bond Proceeds From 1995 Through June 30, 2001

	Revenues (Fund No. 3481)				Bond Proceeds (Fund No. 3482)			Grand Total
	Grants, PEG Fees, and Interest From Viacom*	PEG Fees From TCI	Investment Earnings	Total	Bond Proceeds	Investment Earnings	Total	
1995	\$ 800,000	\$ 0	\$ 4,113	\$ 804,113	\$0	\$0	\$0	\$ 804,113
1996	1,745,101	126,819	70,444	1,942,364	0	0	0	1,942,364
1997	851,760	728,014	171,683	1,751,457	0	0	0	1,751,457
1998	800,000	623,734	252,187	1,675,921	0	0	0	1,675,921
1999	3,476,564	586,860	346,579	4,410,003	8,300,230	274,605	8,574,835	12,984,838
2000	50,000	561,330	371,351	982,681	0	518,069	518,069	1,500,750
2001**	0	272,842	193,751	466,593	0	105,742	105,742	572,335
Total	\$7,723,425	\$2,899,599	\$1,410,108	\$12,033,132	\$8,300,230	\$898,416	\$9,198,646	\$21,231,778

*TCI acquired control of Viacom Cable in 1996.

**Covers the first six months of 2001

SOURCE: ARMS reports

In 1999, the county issued \$94,940,000 limited general obligation bonds to fund various public projects and to refund existing bond obligations. A portion of the bond proceeds in the amount of \$8,284,742 (\$8,300,230 less the bond issuance cost of \$15,488) was to fund the I-Net project. The general obligation bonds related to I-Net are subject to redemption in 16 years. The county's financial plan earmarked the bond proceeds for the cost of installing fiber optic cable at various selected I-Net sites in King County.

The 1996 cable franchise renewal agreement, which covers the period of February 16, 1995 to February 16, 2005, requires the franchisee to collect public, education, and government (PEG) fees at \$1.00 a month from each subscriber located in unincorporated King County area. The collection of the PEG fees started in 1996 and will expire in 2005, unless specifically re-authorized by the Metropolitan King County Council. The

subscribers' fee after 2005, if any, will be determined at the next negotiation for renewal of cable franchise, which could happen before the current franchise agreement expires in 2005.

The franchisee reports and remits the PEG fees to the county on a quarterly basis.

In addition, the cable franchise agreement requires the franchisee to provide the county annual capital grants in the form of cash and construction/work order credits for the county's cable-related and I-Net purposes.³ The capital grants are to be paid to the county through the end of the current franchise agreement in 2005.

The county's Department of Finance invests cash balances in the I-Net funds (Fund Nos. 3481 and 3482). The investment earnings are credited to the I-Net funds.

Expenditures and Encumbrances

The I-Net project was estimated to cost about \$22.5 million. The project budget was comprised of the following components:

• Fiber installation	\$8,068,468
• Electronic installation	9,969,120
• Project management/engineering	2,811,437
• Consulting engineering	190,000
• Operating/user support	<u>1,428,189</u>
Total	<u>\$22,467,214</u>

The project cost to date includes the expenditure for civic television (CTV) in the amount of \$1.24 million. CTV is a county-operated TV cable channel, which airs county-hosted and other governments' programs for public viewing.

³ The annual grants are not considered a part of the franchise fees per contractual agreement.

Exhibit B shows the amount of appropriations as well as expenditures incurred and paid, for the I-Net project from 1995 through June 30, 2001.

EXHIBIT B**I-Net Funds (Fund Nos. 3481 and 3482)****Appropriations and Expenditures From 1995 Through June 30, 2001**

			Fund No. 3481		Fund No. 3482	Funds Total Expenditures	Appropriations Carryover Balance
Appropriations	Cumulative Appropriations		Project Expenditures	Bond Debt Service *	Bond Issuance Cost		
1995	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0
1996	1,200,000	1,200,000	1,103,235			1,103,235	96,765
1997	0	1,200,000	28,336			28,336	68,429
1998	5,164,057	6,364,057	1,042,337			1,042,337	4,190,149
1999	6,828,997	13,193,054	1,350,828	364,709	15,488	1,731,025	9,288,121
2000	7,791,993	20,985,047	3,900,906	734,538		4,635,444	12,444,670
2001	1,492,140	22,477,187					13,936,810
6/30/01**	-6,580,328	15,896,859	5,390,402	180,069		5,570,471	1,786,011
Total	<u>\$15,896,859</u>		<u>\$ 12,816,044</u>	<u>\$1,279,316</u>	<u>\$15,488</u>	<u>\$14,110,848</u>	

* Semi-annual payments due in December and June.

**Covers the first six months of 2001.

Notes: (1) The total amount of encumbrances as of June 30, 2001 amounted to \$5,254,929.

(2) The Metropolitan King County Council approved an appropriation of \$4,370,462 to I-Net Fund No. 3481 in July 2001.

SOURCE: ARMS reports

The budget appropriations and expenditures for the I-Net project from 1996 through June 30, 2001 totaled \$15,896,859 and \$14,110,848, respectively.

FINDING 2-1**REVENUES AND BOND PROCEEDS, AND
EXPENDITURES AND ENCUMBRANCES FOR THE I-NET
PROJECT ACCOUNTED FOR IN THE COUNTY'S
FINANCIAL SYSTEM WERE FAIRLY STATED IN ALL
MATERIAL RESPECTS.**

The audit was planned to obtain reasonable assurance that the revenues and expenditures for the I-Net project were correctly accounted for in all material respects, during the period from 1995 through June 30, 2001. The audit included examining, on a test basis, evidence supporting the amounts of revenues and bond proceeds, and expenditures and encumbrances for the I-Net project to ensure that recorded project life-to-date amounts appear to be fairly stated. Accordingly, we have determined that the cumulative amounts, discussed below, are shown appropriately in the county's accounting records.

As shown in Exhibit A, the I-Net project funds (Fund Nos. 3481 and 3482) had accumulated revenues and bond proceeds of \$21,231,778 from 1995 through June 30, 2001. Details are as follows:

◆ Grants, PEG fees, and interest from Viacom	\$7,723,425
◆ PEG fees from TCI	2,899,599
◆ Investment earnings	2,308,524
◆ Bond proceeds	<u>8,300,230</u>
Total	<u>\$21,231,778</u>

As shown in Exhibit B, the total amount of expenditures for the I-Net project, bond issuance costs, and bond debt service totaled \$14,110,848 from 1995 through June 30, 2001.

The amount of encumbrances, i.e., obligations and commitments for goods and services that have not yet been delivered and/or paid, was \$5,254,929 as of June 30, 2001.

RECOMMENDATION

None

FINDING 2-2**THE I-NET PROJECT HAD REMAINING AVAILABLE FUNDS OF \$1,589,000 AS OF JUNE 30, 2001.**

As noted in Exhibits A and B, showing the amount of revenues and bond proceeds, and expenditures, respectively; the net excess receipts amounted to \$7,121,000 as of June 30, 2001.

This is derived as follows:

Revenues and bond proceeds	\$21,232,000
Expenditures and other disbursements	<u>(14,111,000)</u>
Net excess receipts	<u>\$7,121,000</u>

In June 2001, the amount of encumbrances (goods and services ordered but not yet received and paid) and the liability for the arbitrage profits, as discussed in Finding 2-4, amounted to about \$5,532,000, detailed as follows:

Encumbrances	\$5,255,000
Arbitrage rebate liability	<u>277,000</u>
Total	<u>\$5,532,000</u>

The net excess receipts would be reduced to \$1,589,000 after considering the amount for encumbrances and the arbitrage rebate liability as of June 30, 2001. However, this does not include the subsequent debt service payments and other costs (e.g., staffing, internal service support and project costs) necessary to complete the project or revenues to be collected in the future.

RECOMMENDATION

None

FINDING 2-3**THE COUNTY MAY BE LIABLE FOR ABOUT \$337,000
IN RETAIL SALES/USE TAX FROM THE PURCHASE OF
NETWORKING EQUIPMENT.**

Based on our review of the purchase records of the primary vendor of the network equipment and software, GTE, the county may be liable for the Washington State retail sales/use tax on the value of such purchases. The contract with GTE has standard language, which states that the county will make payment to the state in case the contractor is not registered for payment of sales tax; otherwise, the contractor is to add sales tax to each invoice.

We have determined that, through May 2001, the county received equipment and services and paid the amount of \$3.9 million to GTE. Although the invoices included Washington State retail sales/use tax totaling approximately \$337,000, the payment vouchers requested by I-Net staff and processed by Accounts Payable in the Department of Finance excluded the sales tax. However, the retail sales/use tax invoiced by GTE has been included in the accumulated encumbrance amount. As expressed in the contract language, timely payment of the Washington State sales tax must be made by the contractor or the county. This means that the taxes should have been reported and paid to the state no later than June 2001. We were unable to determine the party responsible for the remittance of the sales tax based on the available documentation. The late reporting and payment of sales/use tax may subject the responsible party to statutory penalty and interest.

RECOMMENDATION**2-3**

The county should determine whether the vendor or the county is responsible for the remittance of sales/use tax on the network equipment and software purchases, and upon determination remit the calculated retail sales/use tax to the appropriate party, either the vendor or the state.

Executive Response

"We have confirmed with the vendor that they have indeed paid the full amount of Washington State Sales Tax that they included on their invoices, well before July 31, 2001, and that there is no outstanding tax liability to the State of Washington. This situation came about because the vendor invoiced King County for multiple items on a single invoice, and some of the items they invoiced were not yet complete and thus not yet billable. When we processed payment for the completed items only, we did not add the pro-rata share of sales tax for those items. Correcting invoices are being issued and we will make the vendor whole for the sales taxes they have paid, but not yet collected from us, on the items that were legitimately billable. For any similar situations in the future, we will include applicable sales taxes to any partial payments."

FINDING 2-4**THE I-NET PROJECT FUND INCURRED AN ARBITRAGE REBATE LIABILITY OF \$277,000 TO THE U.S. TREASURY FROM INVESTING PROCEEDS OF TAX-EXEMPT BONDS IN HIGHER YIELD RATE INVESTMENT INSTRUMENTS THAN STATED ON THE BONDS.**

Arbitrage occurs when a government entity obtains funds through issuance of tax-exempt bonds and notes, and invests the proceeds in securities with a materially higher interest rate than the borrowing rate for the purpose of yielding a profit.

Additionally, such "profit" may occur as a result of holding the investment securities for a period substantially longer than the expected construction period for the bond-funded capital project. Federal laws require that arbitrage profits be calculated, reported, and rebated to the U.S. Treasury Department every five years during the life of a bond issuance.

The general obligation bonds which funded a portion of the I-Net project were issued in May 1999. The bond proceeds were credited to the I-Net bond fund (Fund 3482). While bond proceeds were not being disbursed, and funds from other sources were instead being used to pay for project expenditures, the bond proceeds were invested in investment instruments yielding a higher interest rate than stated interest rate of the bonds. Thus, the bond proceeds generated arbitrage profits that needs to be reported and rebated to the U.S. Treasury. If the bond proceeds had been used first to pay for the I-Net project costs and funds from the project's other revenue sources invested instead, the county could have avoided or minimized rebatable arbitrage profits. This procedure has not been established in a policy.

The county recognized the above situation and set aside funds of \$235,000 in 2000 for the estimated rebatable arbitrage profits. The Department of Finance estimated \$277,000 rebatable arbitrage profits as of June 30, 2001. The amount due to the U.S. Treasury would be finally determined and paid at the end of the five-year reporting period.

RECOMMENDATIONS

- 2-4-1** The county should use proceeds from tax-exempt general obligation bonds first to pay for the I-Net project costs to avoid or minimize arbitrage profit rebates.

Executive Response See below.

- 2-4-2** The Department of Finance should develop a financial policy relating to the priority of disbursing bond proceeds when capital projects are funded by multiple sources of funds.

Executive Response

“We agree with your observations regarding the arbitrage situation. As a matter of practice, we have and will continue to determine the order in which funds are expended based on the circumstances at the time the expenditure decision is made.”

3 CAPITALIZATION OF I-NET PROJECT COSTS AND ENTERPRISE FUND FOR I-NET OPERATIONS

Background

This chapter focuses on the accounting treatment for capitalizing completed components of the I-Net project. Certain portions of the I-Net project are complete and operational, while other areas are still in progress.

The county maintains various separate capital project funds to account for financial resources to be used for the acquisition or construction of major capital facilities or projects. As earlier noted, a separate capital project fund (Fund No. 3481) was created for the I-Net project to account for the PEG revenue and contributions from the franchisee. In addition, another capital project fund (Fund No. 3482) was created to separately account for the proceeds of the general obligation bonds that are earmarked for the I-Net project.

When capital projects are complete, the project costs for constructed capital assets are classified to particular fixed assets accounts for the enterprise fund and the internal service fund, or the general fixed assets account group for the governmental type funds. Subsequently, the capital project funds are closed by county ordinance.

FINDING 3-1**THE PROJECT COSTS RELATED TO CIVIC TELEVISION (CTV), WHICH IS COMPLETE AND OPERATIONAL, SHOULD BE CAPITALIZED AND ACCOUNTED FOR UNDER THE GENERAL FIXED ASSETS ACCOUNT GROUP.**

CTV, which is a county-operated TV channel that provides its citizens access to their government by broadcasting county council meetings, executive weekly news briefings, and other government programs, is included in the I-Net capital project. The CTV project has been complete and operational since 1997. The cost of the CTV project amounted to \$1.24 million. The CTV project component of I-Net should be classified to the general fixed assets group of accounts, in accordance with the existing generally accepted accounting principles (GAAP).

The CTV operation is funded by the current expense fund, since it is considered to be a general government activity.

RECOMMENDATION**3-1**

The capital project costs related to the CTV project should be classified to general fixed assets group of accounts.

Executive Response

"We agree with the recommendations and will commence efforts to accomplish this by the end of 2001."

FINDING 3-2**THE I-NET OPERATION DOES NOT HAVE A SEPARATE FUND TO ACCOUNT FOR ITS OPERATING REVENUES AND EXPENSES, AND ITS OPERATING ACTIVITIES HAVE NOT BEEN BUDGETED.**

Some of the I-Net sites are complete and operational. As of July 2001, 70 I-Net sites are considered revenue-generating sites. Currently, the I-Net operation does not have a separate fund to account for its operating revenues and expenses. The county

intends that the I-Net business be self-sustaining. Hence, an enterprise fund ought to be created, in accordance with GAAP, to account for its “business-like” activities. A fund must be created by council ordinance.

Once an enterprise fund is created, the operating portion of the I-Net sites that are generating revenue should also be considered for capitalization. This accounting procedure is necessary to match appropriate expenditures, including depreciation of fixed assets, against the generated revenues. Such matching of revenues and expenditures is required by GAAP for enterprise activities. The capitalizable costs include the relevant cost of networking equipment and the operational portion of fiber optic installation costs.

Furthermore, we noted that the I-Net operation does not have an approved budget for 2001 to provide the Department of Information and Administrative Services authority to incur and pay expenses for the I-Net operation, although, as noted above, a portion of the network is operating and generating revenues. It appears that the I-Net operation is being funded out of the ITS contingency fund.

RECOMMENDATIONS

- 3-2-1** The executive should submit a proposed ordinance requesting the Metropolitan King County Council to approve the creation of a separate enterprise fund to account for revenues and expenses for the I-Net operation.

Executive Response See below.

- 3-2-2** The executive should submit to the Metropolitan King County Council for its approval a supplemental budget for the I-Net operation in 2001.

Executive Response

"We agree with these recommendations and have already submitted a proposed ordinance and supplemental appropriation request for 2001 operations in the 3rd Quarter Omnibus package. I-Net operations in 2001 are not being funded out of the capital project. Instead, contingency appropriation authority in ITS is being used until the operating fund is established. Operational costs are fully supported by the revenue being collected, and once the operating fund is established, appropriate adjusting entries will be done to transfer the 2001 operating activities into that fund."

3-2-3

The Department of Finance should capitalize the portion of the fiber optic installation costs, networking equipment, and other fixed assets related to the I-Net sites that are operational.

Executive Response

"We agree with the recommendation and will perform this capitalization at the close of 2001 for work completed in 2001, and make subsequent capitalization transactions annually through the close of the project."

APPENDIX

[Blank Page]

APPENDIX

EXECUTIVE RESPONSE



King County Executive
RON SIMS

September 7, 2001

Cheryle A. Broom
King County Auditor
516 Third Avenue, Room W 1020
Seattle, WA 98104-3272

Dear Ms. Broom:

Thank you for the opportunity to respond to the Confidential Draft Report of the Financial Audit of the Institutional Network (I-Net) Project. While I am in general agreement with the findings and recommendations you make in your report, staff from the Department of Information and Administrative Services (DIAS), Department of Finance (DOF), and the Office of Budget (OB) have reviewed this document and provided the following comments to clarify a few issues.

Recommendation 2-3: The County should determine whether the vendor or the County is responsible for the remittance of sales/use tax on the network equipment and software purchases, and upon determination remit the calculated retail sales/use tax to the appropriate party, either the vendor or the state.

Response: We have confirmed with the vendor that they have indeed paid the full amount of Washington State Sales Tax that they included on their invoices, well before July 31, 2001, and that there is no outstanding tax liability to the State of Washington. This situation came about because the vendor invoiced King County for multiple items on a single invoice, and some of the items they invoiced were not yet complete and thus not yet billable. When we processed payment for the completed items only, we did not add the pro-rata share of sales tax for those items. Correcting invoices are being issued and we will make the vendor whole for the sales taxes they have paid, but not yet collected from us, on the items that were legitimately billable. For any similar situations in the future, we will include applicable sales taxes to any partial payments.

KING COUNTY COURTHOUSE 516 THIRD AVENUE, ROOM 400 SEATTLE, WA 98104-3271
(206) 296-4040 296-0194 FAX 296-0200 TDD E-mail: ron.sims@metrokc.gov

 King County is an Equal Opportunity/Affirmative Action Employer and complies with the Americans with Disabilities Act 

APPENDIX (Continued)

Cheryle A. Broom
September 7, 2001
Page 2

Recommendation 2-4-1: The County should use proceeds from tax-exempt general obligation bonds first to pay for the I-Net project costs to avoid or minimize arbitrage profit rebates.

Recommendation 2-4-2: The Department of Finance should develop a financial policy relating to the priority of disbursing bond proceeds when capital projects are funded by multiple sources of funds.

Response: We agree with your observations regarding the arbitrage situation. As a matter of practice, we have and will continue to determine the order in which funds are expended based on the circumstances at the time the expenditure decision is made.

Recommendation 3-1: The capital project costs related to the CTV project should be classified to general fixed assets group of accounts.

Response: We agree with the recommendations and will commence efforts to accomplish this by they end of 2001.

Recommendation 3-2-1: The executive should submit a proposed ordinance requesting the Metropolitan King County Council to approve the creation of a separate enterprise fund to account for revenues and expenses for I-Net operations.

Recommendation 3-2-2: The executive should submit to the Metropolitan King County Council for its approval a supplemental budget for I-Net operations in 2001.

Response: We agree with these recommendations and have already submitted a proposed ordinance and supplemental appropriation request for 2001 operations in the 3rd Quarter Omnibus package. I-Net operations in 2001 are not being funded out of the capital project. Instead, contingency appropriation authority in ITS is being used until the operating fund is established. Operational costs are fully supported by the revenue being collected, and once the operating fund is established, appropriate adjusting entries will be done to transfer the 2001 operating activities into that fund.

Recommendation 3-2-3: The Department of Finance should capitalize the portion of the fiber optic installation costs, networking equipment, and other fixed assets related to I-Net sites that are operational.

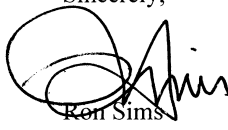
APPENDIX (Continued)

Cheryle A. Broom
September 7, 2001
Page 3

Response: We agree with the recommendation and will perform this capitalization at the close of 2001 for work completed in 2001, and make subsequent capitalization transactions annually through the close of the project.

If you have any further questions or need further information, please contact Kevin Kearns, Manager of the Information and Telecommunications Services Division.

Sincerely,

A handwritten signature in black ink, appearing to read "Ron Sims". The signature is stylized with a large, loopy initial "R" and a series of connected loops for the surname.

King County Executive

cc: Paul Tanaka, Chief Administrative Officer
James Buck, Acting Director, Department of Information and Administrative Services (DIAS)
Kevin Kearns, Manager, Information and Telecommunications Services Division, DIAS
Steve Call, Director, Office of Budget
Bob Cowan, Director, Department of Finance
Dave Lawson, Manager, Executive Audit Services

[Blank Page]

REPORTS BY THE KING COUNTY AUDITOR'S OFFICE

1985 - 1993

- 1985** Alcoholism and Substance Abuse Services Division
Receivables (F)
Test of Real Property Tax Systems Computer Files (F)
Budgetary Staffing Standards (M)
Police Overtime Usage and District Court Scheduling (S)
Roads CIP Budgeting and Staffing Practices Follow-Up (M)
Insurance Fund (F)
King County International Airport (F)
Equipment Management/Utilization, Maintenance, & Replacement Practices (M)
- 1986** Business License Inspection Practices (M)
County Gasoline Contract (M)
Parks Maintenance (M)
Collective Bargaining Agreements (M)
Finance Office Cashiering (M)
Risk Management (M)
H&CD Housing Loans Administration (F)
Public Defense Program Fund Balance Levels (F)
King County Reporting of State Excise Tax (F)
Department of Public Safety, Financial and Personnel Administration (S)
- 1987** Harborview Medical Center Master Plan and CIP (M)
Jail Intake, Transfer, and Releases (M)
County Airport Historical Funding (F)
County Airport Operations (M)
Motor Pool Financing (S)
Meat Inspection Program (M)
- 1988** Accounts Payable (F)
Public Health Pooling Fund (S)
DPH Financing Provisions of 1984 Interlocal Agreement (S)
District Courts Time-Pay Collections Clerks (S)
Political Contributions by Charitable Organizations (S)
Surplus Personal Property (F)
Solid Waste Cashiering (F)
Project Management Cost Allocation Procedures (F)
Court Services (M)
Natural Resources and Parks Division Rental Houses (S)
M/WBE Utilization Requirements for Financial Services Contracts (S)
DPH, County Funded Community-Based Health Clinics and WIC Program (S)
Court Detail, Operation and Staffing (M)
Jail Classification Services (M)
Restaurant Inspection Program (M)
- 1989** Audit Coverage in King County Government (S)
Real Property Records (M)
Solid Waste Accounts Receivable (F)
Department of Public Health Car Rental (S)
Records Management (S)
Department of Public Health, Computer System Planning and Development (S)
Performa '87 (F)
Parks Capital Improvement Program (M)
1988 Consultant Selection Processes for Harborview Capital Projects (S)
- 1990** Jail Intake, Transfer and Release -- Workload, Operations and Staffing (M)
Arbitrage Rebate Requirements on Tax-Exempt Bonds (F)
Conservation Futures (F)
Real Property Sale, Lease & Exchange Practices (M)
Youth Services (M)
Office of Civil Rights & Compliance (M)
Criminal Investigations & Special Operations (M)
Business and Occupation and Public Utility Taxes (F)
Earthquake Preparedness (M)
District Courts and Warrants Division Revenues (S)
State Auditor Use of County Facilities and Equipment (S)
Department of Youth Services Health Program (M)
Code Enforcement Program Building and Land Development Division (M)
Assigned Take Home Vehicles and Agency-Paid Parking (S)
- 1991** Carpentry Shop (F)
County Fuel Station Internal Controls (F)
County Agency Performance Monitoring Survey (S)
King County Elections Practices (M)
King County Purchasing Agency (M)
Farmlands and Open Space Preservation Program (M)
King County Detoxification Center (M)
Dept. of Public Safety Field Training Officer Program (S)
- 1992** King County Office of Emergency Management (S)
King County Dept. of Stadium Administration Revenues (F)
Environmental Health Charges to Solid Waste (S)
Sierra PERMITS Automation System (M)
King County Office of Human Resource Management (M)
BALD Financial Guarantee Administration (M)
Northshore Youth and Family Services (F)
Dept. of Youth Services Drug & Alcohol Program (M)
Dept. Adult Detention & Youth Services Overtime (S)
SEPA Revenues and Accounts Receivable (F)
Methodology for Funding Legal Services for Non-Current Expense Fund Agencies (S)
Accounts Payable (F)
Solid Waste Equipment Replacement Practices (M)
- 1993** Dept. of Development and Environmental Services Assigned Vehicles (M)
Certificate of Occupancy Process (M)
Collection of Civil Penalties and Recovery of Abatement Costs (F)
DDES Field Inspection Function (M)
Police Overtime for Court Appearances (M)
Dept. of Youth Services Sex Offender Unit and Special Sex Offender Dispositional Alternative Program (M)
Office of Open Space Financial Administration (M/F)
Collection Enforcement Section (S)
Cellular Phones (S)
Surface Water Management Service Charges (F)
Acceptance of Special Waste at County Landfills (S)
Solid Waste Division Internal Controls for Handling and

REPORTS BY THE KING COUNTY AUDITOR'S OFFICE

1994 - PRESENT

- 1994** Span of Control (S)
Community Diversion Program (M)
Dept. of Development & Environmental Services Reduction-In-Force Process (S)
Cedar Hills Alcohol Treatment Facility (CHAT) Accounting Procedures and Staffing Levels (M)
DDES Fire Marshal's Office Fire Investigation Unit (S)
DDES Accounts Receivable (F)
Travel Expenses and Credit Card Use (M/F)
Services & Treatment Alternatives for Developmentally Disabled Offenders Incarcerated in the King County Correctional Facility (M)
Board of Appeals and Equalization (S)
Surface Water Management Non-Construction CIP Costs (S)
Tracking and Reporting on Lawsuits Involving King County (S)
Jail Overtime Study Follow-Up (S)
- 1995** Dept. of Metropolitan Services Temporary Contract Workers (M)
King County Purchasing Practices & Supply Contract Prices (M)
Sewage Facilities Capacity Charge (F)
Audit Recommendation Implementation (S)
Dept. of Metropolitan Services Professional Services Contract (M)
Human Services Dept. Monitoring of Contract Compliance (F)
Biomedical Waste Regulation Enforcement (S)
Customer Service Motion Survey (S)
County Fair Financial & Contract Management (F/M)
Supported Employment Program (M)
- 1996** Dept. of Metropolitan Services West Point & Renton Wastewater Treatment Facilities (C)
1990 Code Enforcement Audit Follow-Up (M)
Dept. of Metropolitan Services Compensatory Time Policies, Procedures, and Practices (S)
King County Women's Program (M)
Cultural Programs (Hotel/Motel Tax Distribution) (F/M)
Investment Management (F)
King County Road Construction Fund and Capital Improvement Program (M)
Emerging Infectious Diseases and Laboratory Operations (M)
DUI Offender Program (M)
King County Real Property Acquisition Practices (M)
Seattle-King County Dept. of Public Health (SKCDPH) Immunization Program (M)
- 1997** King County Methadone Treatment Programs (M)
Criminal Justice-Funded Department of Public Safety Staffing (S)
Permit Fee Waivers (M)
Animal Control Section Collection Practices and Interlocal Services (F)
King County Contract for Sobering Services (S)
Office of Civil Rights Enforcement Case Management (S)
Neighborhood Drainage Assistance Program (S)
Surface Water Management Program (S)
Motor Pool (S)
Information and Telecommunications Services (M)
- 1998** Automated Telephone Systems (S)
Interlocal Agreements & Public Agency Contracts (S)
Review of Selected Capital Project Funds (S)
Metro Tunnel Rail Installation Process (M)
Road Maintenance Contracts (F)
ITS Infrastructure Operating and Maintenance Costs (F)
- 1999** Information Technology Planning, Development, and Implementation Processes (M)
East Lake Sammamish Trail (S)
Bond Funded Capital Improvement Projects (F)
King County Traffic Volume Forecast Model (S)
Jail Overtime (S)
Transit Management (C)
Disposition of Firearms (S)
Metro Transit Vehicle Maintenance Operations (M)
Employee Benefits (C)
Risk Management (C)
- 2000** Audit Recommendation Implementation (S)
Sheriff's Office Overtime (M)
Office of Human Resources Management Hiring Practices (M)
Columbia Public Interest Policy Institute (M)
King County Permit Processes and Practices (M)
School Impact Fees (S)
Scale Operator Injury Claims (M)
Parks Department Span of Control (S)
- 2001** Take-Home Vehicle Policies and Practices (M)
Vanpool Replacement and Surplus Practices (M)
Pacific Medical Center Interlocal Agreement (S)
Grading Enforcement at Palmer Junction Gravel Pit (P)
Institutional Network (I-Net) Project (F)
- (C) Audit/Study conducted by consultants
(F) Financial Audit
(M) Management Audit
(P) Performance Audit
(S) Special Study

COMMUNICATION MATERIAL IN ALTERNATIVE FORMAT AVAILABLE UPON REQUEST; PLEASE CONTACT (206)296-1000. TDD NUMBER 296-1024